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Federal Reserve: Keeping the pedal to the metal

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The Fed delivered no more than was expected today, but participants' dot plot projections suggest that they are expecting to keep the pedal to the metal between now and the end of the year when it comes to interest rate hikes. While today's 75bp move brought the target range for the fed funds rate to 3.00%-3.25%, the median dot plot projection for the end of this year is now 4.4%, suggesting policymakers are currently planning further oversized hikes at the next two meetings.

To bring interest rates in line with the median dot plot by the end of the year, the most likely path would be one 75bp and one 50bp move at the next two meetings. However, it should be noted that the distribution of the dot plots suggests a greater likelihood of doing less than this rather than more. Indeed, the number of participants who projected 100bp in cumulative rate hikes over the coming two meetings (8) was very close to the number that projected a cumulative 125bp (9). And, as usual, we don't know which projections are from voting and non-voting members at the current time. Because of this, we are sticking with our forecast for two 50bp hikes at the November and December meetings at this stage.

The median projection for 2023 sees interest rates at 4.6% by the end of next year, before starting to be cut closer to the 2.5% longer-run projection in 2024 and 2025. Whether we see that further interest rate hike next year will be more dependant on how the economy progresses than the immediate decisions this year. While participants downgraded their projections for GDP this year (now only 0.2% Q4/Q4 in 2022) the forecast for 2023 is still a little higher than our own projection (1.2% vs 0.6%). If growth is tracking closer to our forecast, that could be slow enough to bring inflation down a little faster and forgo the need for the final interest rate increase that participants are projecting for 2023.

The FOMC's updated economic forecasts show a closer brush with recession, and the unemployment rate rising a little more than was expected in the prior projections released in June. At a peak of 4.4% that is now expected, we would be nearly 1/2% above the 4.0% long-run jobless rate but still not necessarily a recessionary scenario.

Implications & actions

Re: Economic forecast —The updated median dot plot projection for interest rates next year now sits 50bp above our current forecast. However, the close split between those participants who expect 100bp in cumulative hikes before the end of the year, rather than 125bp, means that we are happy to stick with our base case forecast of a 4.00-4.25% peak at present particularly as our economic projections are a little weaker still than the downgraded median FOMC projections released today.

Re: Markets — Two year bond yields and the US$ jumped immediately after the Federal Reserve decision, largely due to the big upgrade in the median dot plot projection for this year. However, that move faded during the press conference as Chair Powell reiterated that a number of participants were forecasting 100bp in cumulative hikes between now and the end of the year, and that no decision has been made or will be made before those decision dates.

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